Internal Revenue Service

memorandum

CC:TL:BR2
SJHankin

date: AUG 10 1989

to: District Counsel, Manhattan CC:MAN

from: Assistant Chief Counsel, Tax Litigation CC:TL

subject: [redacted]

This responds to your request for technical assistance dated June 30, 1989, with regard to the following issues:

ISSUES

1. Does the exception provided in Treas. Reg. § 1.1502-32(d)(6) which allows a consolidated group to avoid making a negative adjustment to the basis of a subsidiary's stock upon the distribution of preaffiliation earnings and profits, which were carried over pursuant to I.R.C. § 381(c), apply to a Treas. Reg. § 1.1502-32(f)(2) deemed-dividend distribution despite the well-established doctrine prohibiting "double deductions," under the four situations described below 1/:

a. Acquisition occurs after January 1, 1966. Deemed dividend election is made and subsidiary is disposed of prior to August 9, 1979 (Treas. Reg. § 1.1502-32(d)(6) was amended effective August 9, 1979 to eliminate the (d)(6) exception for distributions occurring after August 9, 1979).

b. Acquisition of subsidiary occurs after January 1, 1966. Deemed dividend election is made prior to August 9, 1979, but subsidiary is disposed of after August 9, 1979.

c. Acquisition of subsidiary occurs after January 1, 1966. Deemed dividend election is made and subsidiary is disposed of after August 9, 1979.

d. Acquisition of subsidiary occurs prior to January 1, 1966. Deemed dividend election is made at time of sale after August 9, 1979.

1/ All acquisitions result in the applicability of I.R.C. § 381(a) for carrying over corporate attributes, such as earnings and profits.

2. What is the "distribution" for purposes of determining whether the (d)(6) exception is applicable?

3. How does the answer to Issue 1 change if at the time of the deemed dividend election, the subsidiary had "earnings and profits" accumulated prior to December 31, 1965?

4. How does the answer to Issues 1 and 2 change if affiliates are involved, rather than a subsidiary and parent corporation?

5. What is the purpose of the deemed dividend election and what is it designed to accomplish?

6. In view of the effective date of Treas. Reg. § 1.1502-32 (December 31, 1965), what is the significance of the following to the answers to Issues 1 through 5:

a. Whether the parent was in existence prior to December 31, 1965.

b. Whether the preaffiliation earnings & profits, which were carried over pursuant to I.R.C. § 381(c), were accumulated prior to December 31, 1965.

Issue I

In our view, your request for technical advice essentially asks us to reconsider the position previously reached for the [redacted], as set forth in our letter, dated January 27, 1987, to the Justice Department. Such decision was again reaffirmed in a technical advice memorandum, dated [redacted], sent to Hartford District Counsel in connection with the case of Champion Internal Corporation v. Commissioner (Dkt. No. 14413-87). That is, a decision was made that no negative basis adjustment would be required where a deemed dividend distribution was made prior to August 9, 1979, of the earnings and profits of a subsidiary, which earnings and profits had previously been transferred to that subsidiary pursuant to section 381(c).

It remains our position that a taxpayer-corporation joining in the filing of consolidated tax returns should not be required to make a negative adjustment under Treas. Reg. § 1.1502-32(b)(2)(iii) in its basis in the stock of an affiliated subsidiary upon a deemed dividend distribution (pursuant to Treas. Reg. § 1.1502-32(f)(2)) of the earnings and profits previously transferred to that subsidiary by a nonmember, pursuant to section 381(c). See, the enclosed "defense letter" to the Department of Justice dated, [redacted], and the enclosed technical advice prepared in connection with the case of

Champion Internal Corporation v. Commissioner, Dkt. No. 14413-87. Technical has informally concurred on several occasions with our position not to follow G.C.M. 37577 (June 20, 1978). In that regard, we note that even though the earnings and profits of the target corporation are not reflected in the parent's basis in its stock of the subsidiary, we do not recommend that the negative adjustment to basis issue be litigated.

We recognize that a concession of this issue will allow an affiliated group to include twice into the basis of their subsidiary stock the pre-affiliation earnings and profits of a target corporation which entity was previously merged into that subsidiary. We share your belief that this amounts to a "double deduction." Yet, we believe that no viable argument exists for preventing that result, since Treas. Reg. § 1.1502-32(d)(6), as originally promulgated and as amended in 1979 clearly permits that result for those distributions made prior to August 9, 1979.

Treas. Reg. § 1.1502-32(d)(6) as originally promulgated (effective on January 1, 1966) provided in effect that the general negative basis adjustment for distributions was not required where a subsidiary distributed to its parent pre-affiliation earnings and profits which had been acquired pursuant to section 381(c)(2). The Treasury Decision (TD 6909 LR-1388 (December 29, 1966)) behind the original promulgation of Treas. Reg. § 1.1502-32(d)(6) provides no clear indication of the intent of the drafters in promulgating that provision. Yet, it is commonly understood that such regulatory provision was based on the proposition that if a parent's basis in its subsidiary's stock has not been previously stepped up to reflect the earnings and profits of a target which were previously transferred to that subsidiary, no negative basis adjustment should be required when those earnings and profits are subsequently distributed to the parent as a dividend. In that regard, it appears that the drafters of Treas. Reg. § 1.1502-32(d)(6) were probably under the mistaken belief that in those cases, including presumably triangular mergers, in which the earnings and profits of a target corporation are carried over to a subsidiary under section 381(c)(2), the parent would obtain no basis step-up in its subsidiary stock as a result of the section 381(c)(2) transaction. The Service's position, however, is that in a triangular ("A" or "C") reorganization the parent is entitled to a basis step-up in its subsidiary stock by reason of being entitled to a substitute basis in its subsidiary stock under section 358(a)(1), in an amount equal to the subsidiary's carryover basis in the acquired assets of the target corporation. Hence, Treas. Reg. § 1.1502-32(d)(6), as originally promulgated, permitted a "double deduction" result, and the source of that result was an apparent misconception by its drafters with regard to basis.

Treas. Reg. § 1.1502-32 was amended in 1979 in order to remedy this problem, but on a prospective basis only. That is, Treas. Reg. § 1.1502-32(d)(6) (as amended in 1979) expressly provides that a negative basis adjustment is required with respect to distributions, which are made out of earnings and profits carried over from a nonmember to the subsidiary under section 381(c)(2), but only for those distributions occurring after August 9, 1979. For distributions occurring prior to August 10, 1979, the amended version of Treas. Reg. § 1.1502-32(d)(6) expressly retained the original rule that no negative basis adjustment was required. Accordingly, there is no question that in 1979 Treasury was aware of the defect in the original version of the Treas. Reg. § 1.1502-32(d)(6), but chose to amend the regulation in 1979 on a prospective only basis. Considering the fact that the Service knew of the instant issue when it promulgated the amendments to Treas. Reg. § 1.1502-32(d)(6), the amended regulation must be viewed as conceding the instant issue by way of having made the amendments applicable on a prospective basis only.

To argue (as was done in G.C.M. 37577, 1-450-76 (June 20, 1978)) that Treas. Reg. § 1.1502-32(d)(6) should be interpreted as only applying to actual distributions and not to deemed distributions, made pursuant to Treas. Reg. § 1.1502-32(f)(2), we believe is an argument without merit. That is, certainly a deemed distribution is a distribution. Moreover, Treas. Reg. § 1.1502-32(f)(2) expressly provides that where a deemed dividend election is made the subsidiary shall be treated <u>for all tax purposes</u> as having made a distribution of its accumulated earnings and profits. It would be difficult to argue that the phrase <u>for all tax purposes</u> does not include the exception to the general negative basis adjustment rule of Treas. Reg. § 1.1502-32(b)(2)(iii), as set forth in Treas. Reg. § 1.1502-32(d)(6).

Furthermore, to argue that the exception to the negative basis adjustment rule applies only to actual distributions and not to deemed distributions under Treas. Reg. § 1.1502-32(f)(2) leaves the impression that the "double deduction" result, which apparently exists in the cases you are considering, flows from the interplay of the deemed dividend rule of Treas. Reg. § 1.1502-32(f)(2) and the special exception of Treas. Reg. § 1.1502-32(d)(6) to the basis adjustment rules of Treas. Reg. § 1.1502-32(b)(2). To the contrary, the "double deduction" result is derived from the rule of Treas. Reg. § 1.1502-32(d)(6): that no negative basis adjustment is required where a distribution is made out of preaffiliation earnings and profits which were carried over under section 381(c)(2). This is supported by the fact that the application of Treas. Reg. § 1.1502-32(d)(6) to an <u>actual</u> (pre-1979) dividend distribution will produce the same "double deduction" result produced by a pre-1979 deemed dividend distribution.

Accordingly, any legitimate argument for requiring a negative basis adjustment in these cases ought to be equally applicable to both an actual and a deemed distribution. Yet, no one has even suggested that an actual pre-1979 dividend distribution of preaffiliation earnings and profits which were previously carried over from a nonmember pursuant to section 381(c)(2) should also require a negative basis adjustment. Furthermore, the 1979 amendments to Treas. Reg. § 1.1502-32 revised Treas. Reg. § 1.1502-32(d)(6) while leaving the deemed dividend provision of Treas. Reg. § 1.1502-32(f)(2) totally intact. Hence, it is clear that the drafters of the amendments to Treas. Reg. § 1.1502-32 understood that the "culprit" was Treas. Reg. § 1.1502-32(d)(6) and not the deemed dividend rule. Accordingly, any argument that asserts a negative basis adjustment for a deemed dividend distribution, while not requiring it for an actual dividend distribution, is totally without merit.

As a result of working on other cases with Exam, you seek our views on the affect of various factors on the position taken in [redacted]. We believe that the existence of any of these factors has no affect on the concession position reached by this office for the [redacted]. We are providing you with generalized answers to the various issues raised in your memorandum. Should you, however, desire a case-by-case analysis with regard to those specific cases pending in Exam, you may wish to seek technical advice from the Technical Division.

You have inquired as to whether the above concession position is altered in any way by when the nontaxable acquisition of the subsidiary occurred, or by when the acquired business is disposed of, or by when the deemed-dividend election is made.

In a case where a subsidiary acquires the assets of a nonmember in a transaction to which section 381(a) applies, the rule with regard to negative basis adjustments for distributions made by a subsidiary were and are governed by Treas. Reg. § 1.1502-32(d)(6). Prior to the 1979 amendments, Treas. Reg. § 1.1502-32(d)(6) read as follows:

> (6) Acquisitions of nonmembers -- If a subsidiary acquires the assets of a nonmember in a transaction to which section 381(a) applies, the earnings and profits or deficit in earnings and profits carried over to the subsidiary pursuant to section 381(c)(2) shall not be treated, for purposes of paragraphs (b)(2)(iii) and (c)(2) of this section, as earnings and profits accumulated in prior consolidated return years

beginning after December 31, 1965, or in pre-affiliation years of the subsidiary.

After the 1979 amendments, Treas. Reg. § 1.1502-32(d)(6) reads as follows:

> (6) Acquisition of nonmembers.--If a subsidiary acquires the assets of a nonmember, a negative adjustment is not required under paragraphs (b)(2)(iii) and (c)(2) of this section to the extent a distribution is made out of the earnings and profits carried over from the nonmember to the subsidiary under section 381(c)(2). However, if such a distribution occurs after August 9, 1979, since the distribution is made out of earnings and profit accumulated in a separate return limitation year of the subsidiary, a negative adjustment is required under paragraphs (b)(2)(iii) and (c)(2)(iii) of this section.

Accordingly, the only significant date is the date of the distribution, i.e., whether the date the actual distribution occurs or is deemed to have occurred is after August 9, 1979. Both the date of acquisition of the target entity and the date the acquiring subsidiary is disposed of are irrelevant for the purpose of applying of Treas. Reg. § 1.1502-32(b)(2). As such, only cases where the distribution -- of preaffiliation earnings and profits previously carried over from a nonmember to the distributing corporation pursuant to section 381(c) -- was made or deemed to be made after August 9, 1979 will a negative basis adjustment be required.

ISSUE 2

You have also inquired as to what is the "distribution" for purposes of determining whether the Treas. Reg. § 1.1502-32(d)(6) exception (to making a negative basis adjustment) is applicable. A distribution is a transfer of money or other property by a corporation to a shareholder. Therefore, the date of the distribution is the date that such property is transferred from the corporation to a shareholder.

In the case of a deemed dividend distribution, Treas. Reg. § 1.1502-32(f)(2) expressly provides that where the affiliated group makes a proper deemed dividend election the distributing subsidiary "...shall be treated for all tax purposes as having made a distribution on the first day of such taxable year ...in an amount equal to, and out of, its accumulated earnings and profits on the day preceding such day." Accordingly, a deemed distribution is a "distribution" for purposes of Treas. Reg. § 1.1502-32(d)(6). Furthermore, it is clear that the deemed distribution date is not the date that the target entity was

acquired or disposed of, but rather it is the first day of the year for which the deemed dividend election is made.

ISSUE 3

You have also inquired as to whether the resolution of the negative basis adjustment issue is in any way changed if at the time of the deemed-dividend election, the subsidiary had undistributed earnings and profits that were accumulated prior to December 31, 1965. We assume here that you are referring to undistributed earnings and profits that were accumulated in a separate return year, not in a prior consolidated return year. In any event, we note that for all distributions of pre-1966 earnings and profits accumulated in a prior consolidated return year no negative basis adjustment is required under Treas. Reg. § 1.1502-32(b)(2)(iii).

Where pre-1966 earnings and profits were accumulated in a prior separate return, then to the extent that the subsidiary's distribution is made out of earnings and profits carried over from a nonmember to the subsidiary under section 381(c)(2), the necessity of making a negative adjustment depends on Treas. Reg. § 1.1502-32(d)(6). Under that provision, the date that the earnings and profits were accumulated is not significant. Only the date that such earnings and profits were distributed is significant. As such, if the distribution of such earnings and profits occurs before August 10, 1979, no negative adjustment is required. If, however, the distribution of such earnings and profits occurs after August 9, 1979, a negative adjustment is required.

Accordingly, the conclusions reached in Issue 1 are unaffected by whether the earnings and profits being distributed were accumulated prior to 1966.

Issue 4

You have also inquired as to whether the answers to Issue 1 and Issue 2 would change if the corporations involved are brother-sister corporations. Treas. Reg. § 1.1502-32(f)(2) clearly contemplates that a deemed-dividend distribution can only encompass distributions of a subsidiary to another member corporation owning stock in such subsidiary. No distribution deemed or actual can be made directly between a brother corporation and a sister corporation, unless the brother corporation also owns some of the stock in the sister corporation. Treas. Reg. § 1.1502-32(f)(2) provides that "Each member owning stock in such subsidiary shall be treated for tax purposes as having received an allocable share of such distribution, and as having immediately contributed such allocable share to the capital of the subsidiary." Accordingly,

the conclusions reached in this memorandum, as to whether a negative basis adjustment is required, is unaffected by the fact that more than one member owns stock in the distributing subsidiary. That is, no negative basis adjustment is required with respect to a distribution of pre-1979, preaffiliation earnings and profits, which were carried over from a nonmember pursuant to section 381(c)(2), regardless of the fact that more than one member of the group owns stock in that distributing subsidiary.

ISSUE 5

We believe that the purpose of the deemed-dividend election is to permit an affiliated group filing consolidated tax returns to adjust the basis of its stock of a wholly-owned subsidiary to reflect prior, unreflected earnings and profits. Such rule enables the consolidated return group to capitalize earnings and profits that were presumed not to have previously been reflected in the stock basis. This is done by way of treating those earnings and profits as being distributed by the subsidiary as a dividend and then as being immediately contributed by the parent to the capital of the subsidiary. The deemed dividend provision enables an affiliated group to adjust the basis of the stock of one or more of its wholly-owned subsidiaries, as if from its inception the group filed consolidated returns under the current regulations (post-1979 consolidated return rules). This ensures that upon the disposition of the subsidiary's stock the member holding that stock would not again recognize the same gain which was recognized by the group in a previous consolidated return.

In our view, the Service's own error in promulgating Treas. Reg. § 1.1502-32(d)(6) precludes the Service from arguing that a taxpayer should be required to make a negative basis adjustment, because to do otherwise is at odds with the underlying purpose of the deemed dividend election. cf. Woods Investment Company v. Commissioner, 85 T.C. 274 (1985) Certainly, any taxpayer should be entitled to follow a clearly stated consolidated return rule, even though that rule, because of an erroneous assumption by its drafters, provides an ultimate result not intended by its drafters.

ISSUE 6

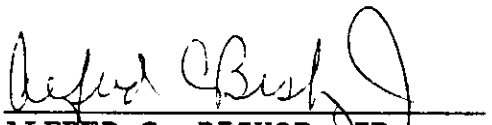
The resolution of the negative basis adjustment issue is in no way affected by whether the parent was or was not in existence prior to December 31, 1965 or whether the preaffiliation earnings and profits, which were carried over pursuant to section 381(c), were accumulated prior to December 31, 1965. Nowhere in the negative basis adjustment rules of Treas. Reg. § 1.1502-32 is there any rule that gives significance as to whether or not the parent corporation was in existence prior to December 31, 1965.

With regard to the distribution of preaffiliation earnings and profits, the only significant date is the date of the distribution, i.e., whether the distribution was made after August 9, 1979. Under Treas. Reg. § 1.1502-32(b)(2)(iii), the date that earnings of a subsidiary were accumulated is only significant where they were accumulated in prior consolidated return years (not to be confused with preaffiliation years of a subsidiary). Since you have not expressed any concerns with earnings and profits accumulated in prior consolidated return years, the above rule has no applicability.

SUMMARY

It continues to be the position of this office that the exception, set forth in Treas. Reg. § 1.1502-32(d)(6), to the investment adjustment rules allows a consolidated return group to avoid making a negative adjustment to the basis of its subsidiary stock where preaffiliation earnings and profits, which had been carried over pursuant to section 381(c)(2), are (by the deemed dividend election) deemed to have been distributed prior to August 9, 1979. Such position is in no way altered by when the target is acquired or by when the acquiring subsidiary is disposed of or by whether the parent corporation was in existence prior to December 31, 1965 or by when the distributed earnings and profits had been accumulated. Only the distribution or deemed distribution date is significant.

MARLENE GROSS

By: 

ALFRED C. BISHOP, JR.
Chief, Branch No. 2
Tax Litigation Division

Enclosures:
Letter to DJ, dated 10/27/87
[redacted]